

F. UPDATE ON CHURCHES

1. Introduction

This topic provides an overview of developments during 1984 that affect churches. As in the past, the 1984 developments emphasize the sensitive nature of the Service's administration of the federal tax laws in the area of churches and religion.

2. Legislative Developments

The Deficit Reduction Act of 1984 contained a number of provisions affecting churches and related organizations. The Act establishes new procedures for examinations of churches and modifies the treatment, for social security purposes, of certain church employees. These developments are discussed in detail in the separate topics in this text on the Deficit Reduction Act and on the Church Audit Procedures.

3. Litigation Developments

A number of court decisions were issued in 1984 that involve churches. One of the more significant decisions was issued by the Seventh Circuit Court of Appeals on October 17, 1984, in the case of Bethel Conservative Mennonite Church v. Commissioner, 84 -2 U.S.T.C. 9870, reversing the Tax Court decision in the case, reported at 80 T.C. 352 (1983). The Tax Court had held that a Mennonite Church was not operated exclusively for religious purposes during years in which it operated a medical aid plan for its members. The plan expenditures accounted for 22 percent of the organization's total disbursements and a substantial portion of the receipts. The medical plan was funded by contributions from the congregation and it restricted its benefits to the congregation. While noting that the organization, without question, undertook religious activities of a traditional nature, the Tax Court stated that, if a church engages in a substantial nonexempt activity, it does not meet the operational test of IRC 501(c)(3) regardless of how substantial its religious or other exempt activities may be. The Tax Court then determined that the medical plan was operated for the private benefit of the church members rather than for an exempt purpose.

The Seventh Circuit, however, observed that one of the "seven ordinances of the Mennonite faith" is to come to the assistance of its needy. The Circuit Court

concluded that the medical aid program simply provided an organized means for the Bethel Mennonite community to implement the long-standing religious belief that they must "bear one another's burdens." The aid plan was thus found to be in furtherance of an exempt purpose and exemption under IRC 501(c)(3) was restored to the Church.

The Tenth Circuit is considering a similar issue on appeal in Mutual Aid Association of the Church of the Brethren v. U.S., reported at the District Court level at 578 F. Supp. 1451 (D.C. KS 1983). In that case, the District Court considered the situation of an Association which lost its exemption under IRC 501(c)(15) in 1972 when its gross income exceeded the \$150,000 statutory limit. Since 1972, the Association has filed Form 1120M. For years 1975 through 1980, it also filed refund claims based on an assertion that it qualifies for exemption under IRC 501(c)(4). The Association provides members of the Mennonite Church with fire and property insurance.

The Association, a separate entity from any church, claims that it is organized and operated to carry out the longstanding Mennonite tenet or belief of sharing losses. As such, the Association claims it is advancing the Mennonite religion and promoting social welfare. The District Court held that advancement of a religious purpose is not per se promotion of social welfare and that the Association's conferral of economic benefits upon its members in the form of rebates or reduced premiums is a substantial nonexempt purpose and is not a necessary incident of its provision of mutual aid for members of the church. Accordingly, exemption under IRC 501(c)(4) is precluded.

The distinction between commercial activity and religious activity was the focus of a third circuit court decision in 1984. The Third Circuit Court of Appeals, in Presbyterian and Reformed Publishing Co. v. Commissioner, 743 F. 2d 148 (3rd Cir. 1984), concluded that a religiously-oriented publishing company continued to qualify for exemption under IRC 501(c)(3). The Court, in reversing a Tax Court decision reported at 79 T.C. 1070 (1982), stated that accumulations of capital for physical expansion and increased business due to increased popularity of one of the publisher's authors did not show a substantial nonexempt purpose. The Court noted that guidance in assessing the nature of an accumulation of funds for purposes of weighing the commerciality of an activity can be found in section 1.537-1(b)(1) of the Income Tax Regulations concerning illegitimate nonpayment of dividends by corporations and accumulations of earnings for anticipated future needs.

Commerciality was also a factor in Church of Scientology of California v. Commissioner, 83 T.C. No. 25 (Sept. 24, 1984). In this case involving the "Mother Church" of Scientology, the Tax Court held valid the Service's 1967 revocation of the organization's exempt status under IRC 501(c)(3) and the assessment of taxes for years 1970 through 1972. The Tax Court found that the organization was not operated exclusively for exempt purposes as it had a substantial commercial purpose manifested in the sale of religious services, books, and artifacts, and in the maintenance of large cash reserves in a sham corporation, and in a bogus trust controlled by church officials including L. Ron Hubbard. Additionally, it was found that net earnings inured to key Scientology officials and that the Church had the illegal purpose of conspiring to impede the Service from collecting taxes due from the organization and its affiliated churches. In conclusion, the Tax Court found that the Church had violated a well-defined public policy against such conspiratorial activities.

In another recent decision, the Tax Court held in Graham v. Commissioner, 83 T.C. No. 30 (October 15, 1984) that payments made by individuals to the Church of Scientology for "auditing" services are not charitable contributions within the meaning of IRC 170(c).

A public policy argument similar to that made in the Scientology case was a factor in Synanon Church v. United States, 579 F. Supp. 967 (D.C.D.C. 1984), which concerned an organization that was incorporated in 1958, for the stated purpose of rehabilitating drug addicts and engaging in related research and public education. The organization was recognized as exempt in 1960 under IRC 501(c)(3). Synanon sought declaratory relief against revocation of its tax exempt status by the Service.

The public policy issue arose in the context of purported illegal activities of Synanon's officers. The government argued that evidence of alleged violent and illegal acts undertaken by Synanon would preclude entitlement to exemption under IRC 501(c)(3). These unlawful acts, according to Synanon's own records, included conspiracy to commit murder, assault and battery, and the cover-up of those activities through destruction of evidence, suborning of perjury and the commission of perjury. Citing the Bob Jones University v. U.S. Supreme Court decision, reported at 103 S. Ct. 2017 (1983), the government argued that an organization which seeks the support and subsidy of the American public through tax exemption must confer a benefit on the public and must not be at odds with common community conscience in a way that undermines the public benefit.

Consequently, the government argued that Synanon's illegal activities violated the purposes of both charitable trusts and established public policy.

The Court dismissed with prejudice Synanon's suit for reinstatement of its exempt status upon a finding that the organization had engaged in a willful, systematic, and extensive destruction and alteration of documents and tapes relevant to the determination of that status. Synanon's egregious misconduct operated as a fraud upon the Court. The Court did not find it necessary to apply the Bob Jones analysis to this case.

As in past years, inurement and private benefit were factors in a number of church court cases.

In Church of Ethereal Joy v. Commissioner, 83 T.C. 20 (1984), the Tax Court, in a declaratory judgment action under IRC 7428, determined that an organization had not engaged in any activities, religious or otherwise, and that one of its three directors participated in the promotion of the organization of mail-order "churches." The court found that the organization had not established that it would be organized and operated exclusively for exempt purposes and therefore it was not entitled to recognition of exemption under IRC 501(c)(3).

In Church By Mail, Inc. v. Commissioner, T.C.M. 1984-349, an extensive record of operations was available for review and, as discussed by the Tax Court, it demonstrated that a direct-mail religious organization, which sought contributions from its members through mailings stating that its members would be blessed if they made contributions, was operated in a manner that caused the net earnings of the organization to inure to the benefit of private individuals. The organization operated a computerized direct mail program that exhorted individuals to contribute money through the use of testimonials which asserted that prior contributors had received sudden gifts of money, houses, automobiles, and airplanes subsequent to their contributions. The organization provided employment, automobiles, and parsonage allowances for the members of the principals' families. The Church was also provided with computer and advertising services by organizations controlled by the principals. The Tax Court upheld the Service's denial of exemption under IRC 501(c)(3).

In National Association of American Churches v. Commissioner, 82 T.C. 18 (1984), the Tax Court reviewed a central organization whose membership consisted of separately incorporated family missions. In addition to the organization's stated religious activities, it assisted the family missions in

incorporating under state law and in handling any tax disputes that arose concerning the missions' claimed tax exempt status. The organization promoted tax seminars for its members in which the tax benefits available to churches were explained. The Court affirmed the Service conclusion that the organization did not qualify for recognition of exemption under IRC 501(c)(3) on the basis that it engaged in the substantial nonexempt purpose of providing financial and tax advice, and particularly tax avoidance counseling.

In Alive Fellowship of Harmonious Living v. Commissioner, T.C.M. 1984-87, by way of contrast with the preceding cases, the Tax Court considered an organization that operated a retreat facility at which it conducted a program of teaching the founder's doctrines. The organization financed its operation through tuition fees, sales of books, and donations. The Tax Court concluded that the organization qualified for recognition of exemption under IRC 501(c)(3) after finding that any social or recreational activities were incidental to the purpose of instructing individuals in the organization's doctrine. Book sales were found to be related to this educational purpose. There was no inurement of net earnings as benefits received by members of the organization were reasonable in relation to the services performed by the members.

Any discussion of developments involving litigation and churches would be incomplete if it did not include a discussion of mail order ministries. Two cases are noteworthy.

The first case involves the Universal Life Church of Modesto, California, which filed on November 8, 1984, in the Claims Court under IRC 7428 for a declaratory judgment on its exempt status under IRC 501(c)(3). The Modesto Church claims to be the parent of a large number of ULC churches nationwide. This Church was initially recognized as exempt in 1976 pursuant to a 1974 District Court decision. However, on August 28, 1984, the organization's exempt status was revoked retroactively to May 1, 1977. The Service action is being challenged by the Church which asserts that the prior 1974 decision controls its exempt status.

The second case is Carter v. U.S., a District Court case in the Northern District of California, No. C-81-2967-WAI (SJ), April 27, 1984. In a jury trial, the plaintiffs were able to prove by a preponderance of the evidence that their chartered congregation of the Universal Life Church was organized and operated exclusively for religious purposes and that no part of the net earnings inured to the benefit of the founders.

The opposite conclusion regarding deductibility or exemption was arrived at by the courts in the following mail order ministry and tax protester cases:

1. Hall v. Commissioner, 729 F. 2d 632 (9th Cir. 1984)
2. Odd v. Commissioner, T.C.M. 1984-180
3. Pollard v. Commissioner, T.C. 1984-536 (35 additional cases were consolidated with this decision)
4. Kile v. Commissioner, 739 F. 2d 265 (7th Cir. 1984) (3 cases consolidated for appeal; the Seventh Circuit awarded attorney's fees and costs to the government based on a finding that the taxpayers' appeals were frivolous. In one of the cases, an appeal from a Tax Court IRC 7428 decision, the Court made the determination on its own motion.)
5. Rondinelli v. Commissioner, T.C.M. 1984-155
6. Johnson v. Commissioner, T.C.M. 1984-164

In addition to the preceding cases, which involved IRC 501(c)(3) or IRC 170 issues, the Service was successful in the following summons enforcement actions involving mail order ministries:

1. Goldberg v. U.S., 586 F. Supp. 92 (D.C. MD 1984)
2. Goodson v. U.S., 53 A.F.T.R. 2d 84-1456 (M.D. AL 1984)
3. Nomura v. Honolulu, 84-1 U.S.T.C. Section 9412 (D.C. HI 1984)
4. Universal Life Church v. U.S., 582 F. Supp. 79 (N.D. CA 1984)
5. Melton v. U.S., 84-1 U.S.T.C. Section 9255 (D.C. AZ 1984)
6. Jahns v. U.S., 84-1 U.S.T.C. Section 9338 (D.C. AZ 1984)